

## Memorandum

**To:** Honorable Carole Migden, Chairwoman  
Honorable Claude Parrish, Vice Chairman  
Honorable Bill Leonard  
Honorable John Chiang  
Honorable Steve Westly

**Date:** April 9, 2003

**From:** Timothy W. Boyer  
Chief Counsel

**Subject:** **The State Assessment of Utilities – Fair Market Value Standard, Available Methodologies, & Changes in Assessment Jurisdiction**

This memorandum is in response to the questions raised by Board Members at the March 26, 2003 Property Tax Committee meeting regarding the appraisal methods and the value standards used in the state assessment of utilities.

As discussed in more detail below, the fair market value standard of Article XIII, section 1 and the provisions of Property Tax Rule 3 require the Board to utilize the same appraisal methodologies in its assessments, including the unitary assessment of electric generation facilities, as those used by the counties in determining the fair market value of property. The Board is required to apply the fair market value standard of Article XIII, section 1 and, therefore, no discretion exists for the Board to apply Article XIII A (i.e., Proposition 13) limitations when valuing state-assessed property.

Regarding assessment jurisdiction, property acquired by a state assessee from a local assessee becomes subject to the Board's assessment jurisdiction as of the date of the transfer. Although the property remains on the local roll until the next lien date, the assessor has no authority to make any assessments of the property for a valuation date that occurs after the property becomes subject to state assessment. Thus, the assessor cannot issue supplemental assessments nor can the Board issue escape assessments as a result of the property's change in ownership. Conversely, property acquired by a local assessee from a state assessee becomes subject to local assessment and the provisions of Article XIII A as of the date of the change in ownership. Although the property remains on the Board roll until the next lien date, the assessor is required to issue supplemental assessments as a result of the change in ownership.

These matters are addressed individually below.

### **LAW AND ANALYSIS**

**QUESTION 1**—May the Board utilize the same appraisal methodologies in its unitary assessments as those used by the counties in determining the fair market value of electric generation facilities? May the Board assess electric generation facilities in conformity with the value limitations of Proposition 13 (i.e., Article XIII A)?

**SUMMARY OF RESPONSE:** The fair market value standard of Article XIII, section 1 and the provisions of Property Tax Rule 3 require the Board to utilize the same appraisal methodologies in its assessments, including the unitary assessment of electric generation facilities, as those used by the counties in determining the fair market value of property. The Board is required to apply the fair market value standard of Article XIII, section 1 and, therefore, no discretion exists for the Board to apply Article XIII A (i.e., Proposition 13) limitations when valuing state-assessed property.

### **DISCUSSION**

Article XIII, section 1 of the California Constitution provides that all taxable property, unless specifically provided elsewhere in the Constitution or in statute, must be valued at fair market value.<sup>1</sup> This value standard applies both to locally-assessed property and to state-assessed property. Article XIII, section 19 provides for the Board's assessment jurisdiction over utilities, requiring annual assessments by the Board.<sup>2</sup> Thus, under Article XIII, section 19, the Board must assess the property of state assessees annually and, under Article XIII, section 1, property must be assessed at fair market value. Section 721 of the Revenue and Taxation Code implements these constitutional provisions by requiring that the Board assess property annually at fair market value.

Under a fair market value standard, the Board utilizes three recognized methods for annually determining fair market value: (1) the cost approach, (2) the comparative sales approach, and (3) the income approach. *De Luz Homes, Inc. v. County of San Diego* (1955) 45 Cal.2d 546, 563-564. Specifically, Property Tax Rule 3 prescribes the application of one or more of the following five approaches to value in order to arrive at fair market value:<sup>3</sup> (1) the comparative sales approach; (2) the stock and debt approach; (3) the replacement or reproduction cost approach; (4) the historical cost approach; and, (5) the income approach. The replacement, reproduction, and historical cost approaches are variations of the cost approach and the stock and debt approach is a variation of the comparative sales approach.<sup>4</sup>

The application of these approaches to state-assessed properties is thoroughly developed and discussed in the *Unitary Valuation Methods* book, a Board publication that describes

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<sup>1</sup> Article XIII, section 1 states in part that:

"Taxable property. Unless otherwise provided by this Constitution or the laws of the United States.

(a) All property is taxable and shall be assessed at the same percentage of fair market value. . . ."

<sup>2</sup> Article XIII, section 19 states in part that "[t]he Board shall annually assess . . . property . . . owned or used by . . . companies transmitting or selling gas or electricity."

<sup>3</sup> Property Tax Rule 1 provides that the rules in that subchapter of the California Code of Regulations applies both to assessors when assessing locally-assessed property and to the Board of Equalization when assessing state-assessed property.

<sup>4</sup> The Board has not considered the stock and debt approach to be a viable valuation approach for determining fair market value for several years.

the valuation methods that are used by staff in its preparation of unitary value indicators.<sup>5</sup>

As part of the Board's annual valuation of state assessees, the Valuation Division calculates value indicators to determine the fair market values of state-assessed properties, based upon the methodologies described in the *Unitary Valuation Methods* book.<sup>6</sup> For the electric generation facility industry group, for example, the Valuation Division will be calculating both a cost approach value indicator (i.e., replacement cost new less depreciation value indicator) and an income approach value indicator (i.e., capitalized earning ability value indicator).<sup>7</sup> Thus, under the fair market value standard of Article XIII, section 1 and Rule 3, the Board must utilize the same appraisal methodologies in its assessments, including the unitary assessment of electric generation facilities, as those used by the counties in determining the value of property.

The fair market value standard prescribed in Article XIII, section 1 precludes the application of Article XIII A, section 2 to state-assessed property, as Article XIII A only applies to locally-assessed property. Article XIII A, by its own terms, is limited to locally-assessed property because it refers to "county assessor's valuation" in the constitutional language. Article XIII A did not constitute a revision of the entire subject of real property taxation, but merely amended the Constitution on certain aspects of the valuation of locally-assessed property. In *ITT World Communications, Inc. v. City and County of San Francisco* (1985) 37 Cal.3d 859, the California Supreme Court ruled that Proposition 13's two percent (2%) limit on annual assessment growth did not apply to state-assessed property.

As the Board is mandated by the Constitution and statutes to value property subject to state assessment annually at fair market value, no discretion exists for the Board to apply Proposition 13 base year values when valuing state-assessed property. Thus, with regard to electric generation facilities (or any other assessee which becomes subject to the Board's assessment jurisdiction), the base year values for these facilities are not a starting point for the Board in determining the fair market value of these assessees, but merely a point of reference to what the fair market values of these facilities may have been in the past.

The electric generation facilities that are returning to the Board's assessment jurisdiction were sold in 1998 and 1999 and became subject to local assessment. The assessors established base year values for these facilities at that time. However, the base year values of these facilities, determined then, may not reflect or approximate the fair market values of these facilities today. Moreover, the base year values for these facilities

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<sup>5</sup> Updates of both this publication and the *State Assessment Manual* were approved by the Board at the March 26, 2003 Property Tax Committee meeting. For locally-assessed property, Assessors' Handbook Section 501, *Basic Appraisal*, and Assessors' Handbook Section 502, *Advanced Appraisal*, have been developed and published to provide appraisal guidelines to assessors regarding these appraisal methodologies.

<sup>6</sup> Property Tax Rule 902 requires that the Valuation Division each year "develop value indicators applicable to the unitary property of each state assessee."

<sup>7</sup> Given the lack of available current sales data for comparable properties, the comparative sales approach value indicator is rarely calculated for state-assessed properties.

adjusted for increases or reductions annually may likewise not be relevant to the current fair market values of these facilities.

If, for example, PG&E sold a facility here in Sacramento County in 1998 for \$300,000,000 to XYZ Energy Corporation and the local assessor enrolled a value reflecting the sales price, the fair market value of that facility may have increased or decreased since 1998. Factors causing a decrease in fair market value could include a decrease in demand for electricity in recent years, the instability of the wholesale price of electricity, the instability of the wholesale and retail electric markets, and economic obsolescence due to the construction of newer, more efficient facilities.<sup>8</sup>

Further, if for 2003 the Board's Valuation Division calculates a replacement cost indicator for this facility at \$225,000,000 and a capitalized earning ability income indicator at \$200,000,000, the value recommended to the Board would be based upon the income indicator. If the Board were to adopt a value of \$200,000,000, the former \$300,000,000 base year value for this same facility would in no way relate to its 2003 fair market value and would have no relevancy to the Board's valuation. However, the assessee would ultimately receive the same fair market value assessment for the property, due to the availability of a decline in value reduction (Proposition 8 assessment), as if the property were locally assessed. In other words, the assessed value of an electric generation facility should be the same whether the facility is state-assessed or locally-assessed, if the fair market value of the property in question is less than its adjusted base year value while under local assessment.

**QUESTION 2**—Compare the assessment issues that arise when the jurisdiction of an assessee changes from local to state assessment and from state to local assessment, including, but not limited to, enrollment, supplemental assessments, and appeal rights.

### **JURISDICTIONAL ISSUES: PROPERTY CHANGING FROM LOCAL TO STATE ASSESSMENT**

Property acquired by a state assessee from a local assessee becomes subject to the Board's assessment jurisdiction as of the date of the transfer. However, the property remains on the local roll until assessed and enrolled by the Board as of the following lien date. The Board will assess the property on the following lien date in accordance with subdivision (b) of Revenue and Taxation Code section 722.5, which provides in part that

. . . real property that becomes subject to board assessment on or after January 1, and on or before the following January 1, shall not be state assessed until the assessment year commencing on the latter January 1.

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<sup>8</sup> Factors causing an increase in fair market value include an increase in demand for electricity, stability in the wholesale price of electricity, and stability in the wholesale and retail electric markets.

Even though a property will not be assessed by the Board until the following January 1, it comes under state jurisdiction on the date of the change in ownership. Once it becomes subject to state assessment, the assessor has no authority to make any assessments of the property for a valuation date that occurs subsequent to the transfer to state assessment. Thus, while the Board's *assessment* authority begins on the date of the transfer that subjects the property to state assessment, the *assessment* and *enrollment* of the property on the Board roll does not occur until the following lien date.

**QUESTION 1:** If a property is kept on the local roll until the next lien date, what valuation methodology is used by the assessor to assess the property during the interim period (i.e., the date of transfer and the following lien date)?

**Answer:** As the assessor has no authority to make any new assessments of the property, the property remains on the local roll at the value previously established by the assessor pursuant to Article XIII A.

This is, in effect, exactly the same system applicable to all real property (both state and locally assessed) prior to the establishment of the supplemental assessment roll in 1983. Under that system, the same assessment remained on the roll after a change in ownership, until the assessment year of the following lien date—since the assessor had no authority to enroll a new base year value until that lien date.

**QUESTION 2:** If a property becomes subject to state assessment as a result of a change in ownership, should supplemental assessments be issued by the assessor? Should supplemental assessments be issued by the assessor for any new construction during this interim period?

**Answer:** No. After a property becomes subject to state assessment, the assessor has no authority to make any new assessments regarding the property. Thus, neither the change in ownership itself, nor any subsequent new construction are subject to supplemental assessment by the assessor. Revenue and Taxation Code section 75.14 states in part that "[a] supplemental assessment pursuant to this chapter shall not be made for any property not subject to the assessment limitations of Article XIII A of the California Constitution." Since the provisions of Article XIII A do not apply to property transferred to a state assessee, no supplemental assessments can occur.

A property becomes subject to the Board's assessment jurisdiction as of the transfer date to a state assessee. The fact that a property will remain on the local roll for tax collection purposes does not mean that the assessor has the continuing authority to assess it or to issue supplemental assessments due to the change in ownership or new construction.

**QUESTION 3:** If the assessment of a property remains on the local roll after the transfer of the property to a state assessee, does the Board issue escape assessments (or refunds)

for the difference between the locally-enrolled value and the state-assessed value for this interim period?

Answer: No. The locally-assessed value remains on the roll for the remainder of the fiscal year. Any difference in value between the state assessment and the local assessment is not recognized until the succeeding lien date.

EXAMPLE: XYZ Energy Corporation sells an electric generation facility in Sacramento County to PG&E on March 1, 2003 for \$250,000,000. The facility had a January 1, 2003 locally-enrolled value of \$200,000,000. The property will remain on the local roll until the January 1, 2004 lien date, based upon its Article XIII A value of \$200,000,000, and no supplemental assessment would be issued by the assessor to recognize the March 1, 2003 change in ownership of the property. Likewise, no escape assessment would be issued by the Board to recognize the March 1, 2003 change in ownership of the property. Instead, the property would be enrolled on the Board roll as of the January 1, 2004 lien date and included in the Board's unitary assessment of PG&E as of that time.

**QUESTION 4:** Who has jurisdiction to hear an appeal relating to the year of the property transfer and what appeal rights would an assessee have?

Answer: If an assessee files an appeal during the period after a property becomes subject to state assessment, but before the property is assessed on the Board roll, the valuation on appeal would relate only to the prior assessment. As that assessment was made on the local roll at the time that the property was subject to local assessment, the local appeals board would have jurisdiction. Consequently, an assessee would have all of the appeal rights as other property owners who hold locally-assessed property.

#### **JURISDICTIONAL ISSUES: PROPERTY CHANGING FROM STATE TO LOCAL ASSESSMENT**

Property acquired by a local assessee from a state assessee becomes subject to local assessment jurisdiction and the provisions of Article XIII A as of the date of the change in ownership. However, except for supplemental roll assessments, as discussed below, the property is assessed on the Board roll until the next lien date.<sup>9</sup> Subdivision (a) of Revenue and Taxation Code section 722.5 provides in part that

Real property assessed by the board . . . which thereafter becomes subject to local assessment, shall not be assessed locally during the remainder of

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<sup>9</sup> For purposes of local assessment, there is a regular roll for the assessment of property as of lien date and the supplemental roll for the assessment of property due to changes in ownership or new construction. For purposes of state assessment, however, there is only one roll—the Board roll, for the valuation of property as of the lien date.

the assessment year, except as provided in Chapter 3.5 (commencing with Section 75) of Part 0.5 of Division 1.

**QUESTION 1:** If a property is assessed on the Board roll, except for purposes of supplemental assessment, what valuation methodology is used by the Board to assess the property during the interim period (i.e., the date of transfer and the following lien date)?

**Answer:** The property remains on the Board roll assessed at the fair market value determined as of the current lien date.

**QUESTION 2:** If a property becomes subject to local assessment as a result of a change in ownership, should supplemental assessments be issued by the assessor? Should supplemental assessments be issued by the assessor for any new construction during this interim period?

Property acquired by a local assessee from a state assessee is subject to supplemental assessment by the assessor as a result of the change in ownership. As quoted above, subdivision (a) of section 722.5 contains specific references implicitly authorizing supplemental assessments pursuant to Revenue and Taxation Code sections 75 and following.

Thus, the assessor should issue a supplemental assessment or assessments for the difference between the property's new base year value as established by the assessor and the taxable value on the current Board roll. The taxable value on the current Board roll is the portion of the state-assessed value allocable to the subject property. Supplemental assessments should likewise be issued by the assessor for any new construction during the interim period.

**EXAMPLE:** PG&E sells an electric generation facility in Sacramento County to XYZ Energy Corporation on March 1, 2003 for \$250,000,000. The facility had a January 1, 2003 allocated value of \$200,000,000, as a portion of PG&E's unitary assessment. Although the property will remain on the Board roll until the January 1, 2004 lien date, two supplemental assessments would be issued by the assessor, pursuant to section 722.5 and section 75.11, subdivision (a), to recognize the March 1, 2003 change in ownership of the property. The property would be assessed on the regular local roll as of the January 1, 2004 lien date.

**QUESTION 3:** Who has jurisdiction to hear an appeal relating to the year of the property transfer and what appeal rights would an assessee have?

**Answer:** If an assessee files an appeal during the period after a state-assessed property becomes subject to local assessment, but before the property is assessed on the regular local roll, the valuation on appeal would relate to the prior assessment. As that assessment was made on the Board roll at the time that the property was subject to state assessment, the Board would have jurisdiction. Consequently, an assessee would have all of the appeal rights as other state assessees.

Honorable Board Members

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Thank you for your inquiry. Please feel free to request our response to any further questions concerning this matter.

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